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In the Supreme Court of the United States

OCTOBER TERM, 1970

UNITED STATES OF AMERICA, APPELLANT

v.

MARYLAND SAVINGS-SHARE INSURANCE CORPORATION

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

JURISDICTIONAL STATEMENT

ERWIN N. GRISWOLD,
Solicitor General,

JEROME M. FEIT,
Assistant Attorney General,

WILLIAM KANTER,
WILLIAM J. COLLINAN,
RICHARD J. FAUCHEUX,
Attorneys,

Department of Justice,
Washington, D. C. 20530.

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JURISDICTIONAL STATEMENT

OPINION BELOW

The opinion of the district court (Appendix A, *infra*, pp. 15-35) is reported at 308 F. Supp. 761.

JURISDICTION

The judgment of the district court (Appendix B, *infra*, p. 37) was entered on January 22, 1970. A notice of appeal was filed in the district court on February 19, 1970. On April 15, 1970, the Chief Justice extended the time for docketing the appeal to and

including May 20, 1970. The jurisdiction of this Court rests on 28 U.S.C. 1252, which provides for a direct appeal to this Court from a final judgment of a court of the United States holding an Act of Congress unconstitutional in a civil action to which the United States is a party. See, *e.g.*, *Clark* v. *Gabriel*, 393 U.S. 256; *United States* v. *Raines*, 362 U.S. 17.

QUESTIONS PRESENTED

1. Whether the district court erred in holding that Section 501(c)(14)(B) of the Internal Revenue Code of 1954, which limits the exemption from income tax for mutual insurers to those organized before September 1, 1957, creates an arbitrary and unreasonable classification violative of the due process clause of the Fifth Amendment.

2. If the cut-off date provided in Section 501(c)(14)(B) is unconstitutional, whether the district court erred in broadening the exemption to include mutual insurers organized on or after September 1, 1957, rather than denying the exemption to all insurers by invalidating Section 501(c)(14)(B) in its entirety.

STATUTES INVOLVED

The pertinent provisions of Sections 115 and 501 of the Internal Revenue Code of 1954 are set forth in Appendix C, *infra*, pp. 39-40.

STATEMENT

Following serious losses to shareholders (savings account depositors) in Maryland savings and loan as-

sociations, the Maryland legislature created the Maryland Savings-Share Insurance Corporation ("MSSIC") in 1962 as a non-stock, non-profit corporation. Md. Ann. Code, Art. 23, §§ 161MM-161 AAA. Its members are building, savings and loan, and homestead associations organized under the laws of or authorized to do business in the state of Maryland. Md. Ann. Code, Art. 23, §§ 161WW(4) and 161YY. MSSIC's purposes are to insure the savings accounts of its members' shareholders, to provide its members liquidity by making loans to them from a central reserve fund maintained for this purpose, and to promote the elasticity and flexibility of its members' resources by providing other financial assistance. Md. Ann. Code, Art. 23, §161NN. (Appendix A, *infra*, pp. 15-16.)

The faith and credit of the State of Maryland is not pledged to secure MSSIC's obligations. Ann. Md. Code, Art 23, § 161RR. MSSIC's capital consists of contributions from member associations of two percent of their savings accounts and the investment income earned on the contributions (Appendix A, *infra*, p. 16). Taxation of the investment income is questioned in this action.

MSSIC paid income taxes of $40,898.02 for the period from September 1, 1963, to December 31, 1966,

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[1] The separate amounts paid for each of the taxable periods involved are as follows:

September 1, 1963	— August 31, 1964	—	$ 1,071.40
September 1, 1964	— December 31, 1964	—	3,658.40
January 1, 1965	— December 31, 1965	—	16,995.35
January 1, 1966	— December 31, 1966	—	19,172.87

and here seeks refund of that amount, together with interest. MSSIC contended below that its investment income is excludable from gross income under Section 115(a)(1) of the Internal Revenue Code (Appendix C, *infra*, p. 39)[2]; that it is exempt from tax under the doctrine of intergovernmental immunity; and that it is constitutionally entitled to exemption under Section 501(c)(14)(B) of the Code, which provides for exemption of non-profit mutual insurers like MSSIC, but only if they were "organized before September 1, 1957."

The district court rejected MSSIC's first two claims, but found for MSSIC on the constitutional ground. Although Section 501(c)(14)(B) as enacted does not exempt organizations like MSSIC created on or after September 1, 1957, the district court concluded that the restriction of the exemption to institutions organized before that date is an arbitrary classification, and denies MSSIC the due process required by the Fifth Amendment (Appendix A, *infra*, p. 35). The court excised the cut-off date from the statute, and granted MSSIC the refund it sought.

This appeal is taken from the holding that the cut-off date provision is unconstitutional, and the judgment granting the refund.

THE QUESTIONS ARE SUBSTANTIAL

The decision below should be reviewed because it invalidates part of an Act of Congress on a basis

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[2] Section 115(a)(1) excludes from "gross income" income derived from "the exercise of any essential governmental function and accruing to a State * * *."

which finds no support in this Court's decisions. Although the decision itself applies to only a few taxpayers,[3] its rationale draws into question the power of Congress to limit exemptions from tax through the use of "grandfather clauses," and otherwise to make tax classifications on the basis of the dates of occurrence of transactions or other events. Since the Internal Revenue Code has numerous provisions of this sort,[4] the decision below, if affirmed, could have a significant unsettling influence on the administration of the tax laws.

More generally, the decision below draws into question congressional power to make changes in the law with prospective effect in an area where the making of such determinations is part of the annual work of

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[3] We are advised by the Internal Revenue Service that there is only one state mutual insurer, in addition to MSSIC, which was organized on or after September 1, 1957, the North Carolina Savings Corporation. Only three such insurers organized before September 1, 1957, are still in existence. These are the Co-operative Central Bank and the Mutual Savings Central Fund, both organized in Massachusetts, and the Ohio Deposit Guaranty Fund. Two other mutual insurers, organized in Connecticut and New Hampshire prior to the cut-off date, are no longer in existence.

[4] See, for example, the following Sections of the Internal Revenue Code of 1954, as amended: 49; 83(a), (i); 110; 152(b)(3); 163(d)(6); 165(i); 167(j)(3) and (*l*); 170(b)(1)(C); 172(b)(1)(E); 247(a), (b)(2); 342(a); 402(b), (d); 404(a), (c); 501(c)(14)(C); 512(a), (b)(13) and (b)(16); 513(a)(2); 592; 642(c)(2); 1014(b)(7), (8); 1016(a)(2), (3); 1019; 1020; 1033(a)(2), (b) and (g); 1034(i); 1052; 1053; 1081(c); 1082(a)(3); 1111(d); 1212(b)(3); 1223(7); 1232(a)(1), (a)(2)(B); 1234(d)(4); 1240; 1321(a), (c); 1341(b)(2); 1347; 1441(b); 1564(b); 2036(b); 2038(a), (c); and 2106(c).

Congress. As the statutory law develops, Congress is often required to make a judgment as to whether new rules are to be applied to taxpayers or situations already in existence. We know of no decision in which a provision of this sort in the Code has been struck down as being unconstitutionally discriminatory. In holding Section 501(c)(14)(B) invalid on that ground, the court below cast doubt on many provisions of the Code, which, like Section 501(c)(14)(B), result in some difference in tax treatment between taxpayers based on chronological distinctions.

1. The decision below is inconsistent in its approach with this Court's decision in *O'Malley* v. *Woodrough*, 307 U.S. 277. That case involved the validity of Section 22 of the Revenue Act of 1936 (c. 690, 49 Stat. 1648, 1657) which (as in the corresponding provisions of the Revenue Acts of 1932 and 1934) subjected to federal income tax the salaries of federal judges "taking office after June 6, 1932." Although the basic issue in *Woodrough* was whether any tax on the salaries of federal judges was consistent with the Constitutional provision against the diminution of judicial salaries, a question essentially similar to that before the Court here was necessarily involved. The statute there expressed a change of policy by Congress, which Congress made applicable only to judges thereafter appointed. The Court pointed this out in referring to the fact that Judge Woodrough had "notice * * * of the new Congressional policy to include the judicial salaries of [judges appointed after June 6, 1932] in the assessment of income taxes." 307 U.S. at 279. And the

Court stated the question before it to be "whether Congress exceeded its constitutional power in providing that United States judges appointed after the Revenue Act of 1932 shall not enjoy immunity from the incidences of taxation * * *." 307 U.S. at 281-282. Thus the cut-off date was clearly stated, and the issue of discrimination between two classes of judges—those appointed before, and those appointed after, June 6, 1932—was directly before the Court. That this question of chronological classification was not regarded as raising a serious issue sheds clear light on the unsoundness of the decision below in the present case.

In the *Woodrough* case, as here, Congress terminated a pre-existing exemption, with a cut-off date limiting the operation of the change to new members of the class. There, as here, the taxpayer had notice of the situation at the time he entered the field, after the cut-off date. There is no more reason here than there was in *Woodrough* to regard it as beyond the power of Congress to make the change in the law inapplicable to those who were committed before the change was determined upon and went into effect.

2. Section 501(c)(14)(B) originated in Section 313 of the Revenue Act of 1951 (c. 521, 65 Stat. 452, 490). The latter section, in general, eliminated the exemption from tax theretofore granted to all savings and loan institutions, including building and loan associations and mutual and cooperative savings banks, all of which are operated for profit. An exception was provided, however, which preserved the exemption for non-profit mutual insurers organized before

September 1, 1951. The exception was approved only after Congress received assurances that the exemption would be available only to the four mutual insurers then in existence. See letter dated January 20, 1960, from Jay W. Glasmann, Assistant to the Secretary of the Treasury, to Senator Harry F. Byrd, Chairman, Senate Finance Committee, in S. Rep. No. 1034, 86th Cong., 2d Sess., pp. 3-4, set out in Appendix D, *infra*, pp. 41-43.

Since Congress' principal purpose in enacting Section 313 of the 1951 Act was to withdraw the previously existing industry-wide exemption, it would seem entirely within legislative prerogatives for Congress to have determined that existing organizations, formed in reliance on the exemption, should continue to be exempt through the use of a "grandfather clause," but that new organizations, thereafter formed, with notice of the change in the statute, would not enjoy the exemption. Likewise within the proper sphere of legislative judgment was the decision of Congress in 1960 to change the original cut-off date of Section 501(c)(14)[3] from September 1, 1951, to September 1, 1957, in order to extend the exemption to the Ohio Deposit Guaranty Fund, which had been organized in 1956. See Appendix A, *infra*, pp. 29-30. In 1960, it was clear that, despite the 1951 legislation, savings and loan institutions were still virtually exempt from tax because of an over-generous allowance for bad debts (see Appendix A, *infra*, p.

[3] Act of April 22, 1960, P.L. 86-428, 74 Stat. 54, Sec. 1.

30).[6] Under these circumstances, an exercise of congressional judgment, either favorable or unfavorable to the Ohio Fund, plainly would have been constitutionally permissible.

3. There is, moreover, a valid regulatory purpose underlying the cut-off date in Section 501(c)(14)(B), notwithstanding the district court's conclusion to the contrary. See Appendix A, *infra*, p. 34. This purpose emerges quite clearly from the legislative history of H.R. 3297, a bill introduced in 1963 at MSSIC's instance (109 Cong. Rec., Part 2, p. 1670), which would have changed the cut-off date from September 1, 1957, to January 1, 1963. The bill passed in the House (109 Cong. Rec., Part 9, p. 11809) on the recommendation of the Ways and Means Committee (H. Rep. No. 459, 88th Cong., 1st Sess.), but was never reported out by the Senate Finance Committee. As appears from the Finance Committee's hearing on the bill (see Statement by Joseph P. McMurray, Chairman, Federal Home Loan Bank Board, in Hearing before the Senate Committee on Finance on H.R. 3297, 88th Cong., 2d Sess., pp. 9-10, set out in Appendix E, *infra*, pp. 45-49), the Federal Home Loan Bank Board opposed the change in the cut-off date because (Appendix E, *infra*, p. 46) it might "encourage the formation of other State-authorized insurance corporations which would reasonably expect similar income tax treatment and the Board does

[6] The industry first became subject to an effective tax as a result of the enactment of Section 6(a) of the Revenue Act of 1962 (P.L. 87-834, 76 Stat. 960, 977), which amended Section 593 of the 1954 Code.

not favor encouraging the proliferation of such corporations." Among the reasons for the Board's opposition to proliferation was that "financial institutions have broad interdependence and failure of any State-authorized insurance fund may have adverse repercussions on FSLIC [The Federal Savings and Loan Insurance Corporation] and institutions insured by it."[7] *Id.*, pp. 46-47.

The government has a legitimate interest in protecting FSLIC, which it created to insure shareholders of state and federally chartered savings and loan associations, 12 U.S.C. 1725, and which, *inter alia*, encourages savings and promotes economic stability. As Mr. McMurray's statement makes clear, confidence in FSLIC might be eroded if one or more state mutual insurers were to fail. Given this problem, it was reasonable for Congress to attempt to deter new entrants into the field by denying additional tax exemptions.[8]

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[7] Our reliance on the legislative history of H.R. 3297 is appropriate even though the failure of Congress to enact legislation cannot ordinarily be taken as an indication of its intent and though, in any event, such a failure does not clarify the intent of an earlier Congress. See, *e.g.*, *United States* v. *Webb*, No. 63, this Term, sl. op. p. 15, n. 21, decided March 3, 1970. The problem here is not one of divining congressional intent but of determining whether MSSIC has satisfied its "burden * * * to negative every conceivable basis which might support" the distinction drawn in Section 501 (c) (14) (B). *Madden* v. *Kentucky*, 309 U.S. 83, 88; see *Allied Stores* v. *Bowers*, 358 U.S. 522, 528; *McGowan* v. *Maryland*, 366 U.S. 420, 426.

[8] Governmental policy consistent with the position taken by the Federal Home Loan Bank Board is not negatived by

4. In holding that the cut-off date in Section 501 (c) (14) (B) was unconstitutional, the district court relied on *Mayflower Farms, Inc.* v. *Ten Eyck*, 297 U.S. 266. That case, however, differs from this one in a number of critical respects. First, as the district court itself recognized (Appendix A, *infra*, pp. 33-34), MSSIC, unlike the party claiming discrimination in *Mayflower Farms*, was not in existence when the cut-off date provision was enacted. MSSIC knew when it was organized that it would be taxable under the statute. Second, this Court pointed out in *Mayflower Farms* (297 U.S. at p. 274) that the statute there in question was "an attempt to give an economic advantage to those engaged in a given business at an arbitrary date as against all those who enter the industry after that date." Section 501(c)(14)(B), on the other hand, is limited by its terms to nonprofit organizations, and MSSIC, by its nature, does not compete with any mutual insurer which qualifies for exemption, so as to be in a position to allege a competitive disadvantage. Finally, the effect of the statute in *Mayflower Farms* was to put an existing enterprise out of business. No claim has been made by MSSIC that Section 501(c)(14)(B) will have a

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Congress' grant of exemption to the Ohio Guarantee Fund in 1960. See pp. 8-9, *supra*. Since the entire savings and loan industry was still exempt from tax (as a practical matter) at that time, it was within Congress' discretion to determine that the policy of protection for FSLIC should give way to the overall tax policy then applicable to the industry. There was some doubt even in 1964 whether Congress had exercised its discretion wisely in extending the exemption to the Ohio Fund. See Senate Hearing on H.R. 3297, *supra*, p. 34.

similar effect. In short, there are lacking here any of the factors that led this Court to conclude that the cut-off date provision in *Mayflower Farms* imposed an injury of constitutional dimensions.[9]

5. If the Court should hold that Section 501(c)(14)(B) unconstitutionally discriminates against MSSIC, the further question would be raised as to whether the district court was correct in extending the exemption to MSSIC by excising the cut-off date from the statute, or whether the entire section should fall because of the discrimination, with the result that no mutual insurer would be entitled to exemption. Since Congress conceived of Section 501(c)(14)(B) as a limited exception to its principal purpose of removing the tax exemption previously ac-

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[9] Although the district court agreed that *Mayflower Farms* was distinguishable, it nevertheless was "impressed with the fact that a cutoff date in a legislative enactment was [there] subjected to judicial scrutiny and found to be a denial of equal protection." Appendix A, *infra*, p. 34. The court's reliance on this fact affords no basis for affirmance of its decision, since this Court has on numerous occasions sustained cut-off dates in various types of legislation against claims of unconstitutional discrimination. See, *e.g.*, *Stanley* v. *Utilities Commission*, 295 U.S. 76 (statute requiring common carriers to obtain certificates of public convenience and necessity, but excepting carriers providing service before a specified date); *Sampere* v. *New Orleans*, 279 U.S. 812 (*per curiam*) (statute excepting prior non-conforming uses from a new zoning restriction); *Sperry & Hutchinson* v. *Rhodes*, 220 U.S. 502 (statute forbidding the unauthorized use of a living person's photograph, but excepting photographs taken before the effective date of the statute); *Watson* v. *Maryland*, 218 U.S. 173 (statute excepting physicians practicing before a specified date from state licensing requirements). Cf. *Desist* v. *United States*, 394 U.S. 244.

corded the entire savings and loan industry, and since it regarded the cut-off date as vital (see pp. 7-8, *supra*), it seems clear that it would not have approved any exemption which did not by its terms close the class exempted as of the date of enactment. In this situation, if anything is to be excised from the statute on the ground of discrimination, it should be the whole exemption provision. From this we believe it follows that the district court erred in granting a refund to MSSIC even if the cut-off date in Section 501(c)(14)(B) is unconstitutional. See *Davis* v. *Wallace*, 257 U.S. 478, 484-485; *Frost* v. *Corporation Commission*, 278 U.S. 515, 525; *Kirk* v. *Commissioner*, C.A.D.C., No. 22,901, decided March 9, 1970; see also *Morey* v. *Doud*, 354 U.S. 457, 469-470.

CONCLUSION

For the reasons stated, probable jurisdiction should be noted.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

JOHNNIE M. WALTERS,
Assistant Attorney General.

WILLIAM MASSAR,
WILLIAM L. GOLDMAN,
RICHARD S. HALBERSTEIN,
Attorneys.

MAY 1970.

APPENDIX A

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

No. 19330

Civil Action

MARYLAND SAVINGS-SHARE INSURANCE CORPORATION

v.

UNITED STATES OF AMERICA

Filed: January 22, 1970

Richard W. Case and P. Dennis Belman, Baltimore, Maryland, for plaintiff

Stephen H. Sachs, United States Attorney, and Alan B. Lipson, Assistant United States Attorney, Baltimore, Maryland, and Edward J. Snyder, Department of Justice, Washington, D. C. for the United States

Northrop, District Judge

Maryland Savings-Share Insurance Corporation, a Maryland corporation, seeks to recover $40,898.02 paid to the United States Treasury as federal income tax. This court concludes that Maryland Savings-Share Insurance Corporation is entitled to the refund.

Maryland Savings-Share Insurance Corporation (MSSIC) is a non-profit corporation created by the Maryland legislature under a special statutory charter. The primary purpose of the corporation is to insure the free-share accounts of member savings and loan associations, but it also serves to promote the elasticity and flexibility of the resources of member

associations and to aid the liquidity of member associations by providing a central reserve fund. In the late 1950's and early 1960's a number of savings and loan associations collapsed. The lack of state control over these institutions made the citizens of Maryland fair game for shady operators. The public was bilked out of millions. Many persons lost their life savings. There was a scandal of considerable magnitude. The governor responded to the situation by creating two commissions which studied the savings and loan industry and proposed legislation regulating it. The commissions' study of the industry also showed that there was no existing private corporation which could adequately insure the deposits of the associations, so the commissions also proposed that the state create an insurer for those savings and loans which did not qualify for federal insurance programs. MSSIC was created by a special act of the Maryland General Assembly. *See.* Md. ANN. CODE art. 23, sec. 161MM-161AAA (1968). Three of the eleven members of MSSIC's board of directors are selected by the governor. No association may become a member of MSSIC without first having been approved by the State Department of Building, Savings and Loan Associations. Bylaws of the corporation may not be changed without the approval of the Department of Building, Savings and Loan Associations. MSSIC's charter, however, explicitly provides that neither the faith nor the credit of the state is pledged to MSSIC's obligations. MD. ANN. CODE art. 23, sec. 161RR. The source of MSSIC's capital is the contribution by member associations of two percent of their free-share accounts, and the earnings from the investment of such contributions by member associations. The corporation's charter specifically provides that no part of the earnings of the corporation shall be returned to mem-

ber associations; but, since no provision is made for distribution of accumulated income, any such accumulated income would presumably escheat to the state upon the dissolution of MSSIC. *See* MD. ANN. CODE art. 23, sec. 161NN(c). It is only in that sense that MSSIC can be said to be financially related to the state.

MSSIC asserts that it should be exempt from federal income taxes. It gives three reasons. First, MSSIC claims its income is exempt under INT. REV. CODE of 1954, sec. 115(a)(1), which exempts income derived from the exercise of an "essential governmental function" and "accruing" to the state or a political subdivision thereof. Second, MSSIC asserts that it is immune from federal income taxation by reason of the doctrine of intergovernmental tax immunity. Third, MSSIC claims that the 1957 cutoff date in INT. REV. CODE of 1954, section 501(c)(14), which section exempts essentially identical corporations from taxation, is arbitrary and, as such, a denial of the right to due process guaranteed by the Fifth Amendment.

MSSIC's statutory claim under INT. REV. CODE of 1954, sec. 115(a)(1), does not reach the constitutional proportions its other claims reach, so it will be considered first. In order to qualify for exemption under INT. REV. CODE of 1954, sec. 115(a)(1) income must both be derived from an "essential governmental function" and "accrue" to the state. The United States argues that MSSIC's income does not "accrue" to the state of Maryland. It asserts that accrual is to be taken in an accounting sense and that the mere possibility of an escheat to the state upon dissolution does not constitute an accrual.

In support of its position the United States cites *Omaha Public Power District* v. *O'Malley*, 232 F. 2d

805 (8th Cir. 1959). In that case a nonprofit citizens' group, anticipating Nebraska legislation that would establish a power district as a public corporation and political subdivision and themselves interested in insuring that the utilities were in fact placed under the control of such a corporation, purchased all the stock of a Nebraska power company. The power company, however, supplied services to both Nebraska and Iowa. Doubtful as to whether the power district could lawfully carry on operations outside Nebraska, the citizens' group set up an Iowa corporation for the purpose of operating those facilities located in Iowa. It was contemplated that the Iowa corporation would be sold as soon as was practicable and the proceeds of the sale paid to the Nebraska power district. The Iowa corporation paid no dividends during the period involved, so the group of private citizens itself received no income from the transaction. Federal income taxes were imposed on the Iowa corporation, and the power district sought a refund under the 1939 Code equivalent of section 115(a)(1), section 116(d). The power district claimed that the term "accruing" means "inuring". It argued that the Iowa corporation's receipt of income "inured" to the power district and that that was enough to meet the accrual test. The Eighth Circuit concluded that the accrual test was not met. It construed "accrue" to mean vesting as an enforceable right. The United States argues that the *Omaha Public Power District* case establishes that accrual to a corporate entity separate from the state is not a sufficient accrual to the state. Given the kind of corporate entity involved in *Omaha Public Power District*, the United State's contention is correct. *Accord*, *Burlington* v. *United States*, 148 F. 2d 887 (8th Cir. 1945). In Revenue Ruling 59-41, 1959-1 CUM. BULL. 13, on the other

hand, the income of a nonprofit corporation established by a municipality under the general laws of the state for the purpose of purchasing a water system was held not to be taxable. There, however, the municipality in question was to get title to the water system when the corporation's indebtedness was paid in full. Furthermore, surplus income of the current year was paid to the municipality's general fund. Thus, Revenue Ruling 59-41 would seem to establish that accrual to a corporate entity distinctly separate from the state may be deemed an accrual to the state. That ruling, however, did not purport to construe section 115(a). It merely concluded that the income would not be deemed income within the meaning of section 61 of the Internal Revenue Code. In light of that ruling, however, it cannot be said that accrual to MSSIC is not an accrual to the state simply because MSSIC is a corporation. At the same time, the situations described in both *Omaha Public Power District* and Revenue Ruling 59-41 are factually distinguishable from the MSSIC situation. The corporation in question in *Omaha Public Power District* was a profit corporation organized under the general corporation statute of the state; MSSIC is a nonprofit corporation created by special statutory charter by the state legislature. In Revenue Ruling 59-41, the municipality in question was to get title to the water system when the corporation's indebtedness was paid in full and the corporation's accumulated income of the current year was paid into the municipality's general fund; the state of Maryland has no interest in the capital contributed by member associations and accumulated income would be paid to the state only in the event of an escheat upon dissolution of the corporation.

MSSIC asserts that the required accrual to the state occurs when MSSIC realizes income on its in-

vestment of the capital contribution of its members. MSSIC argues that many state departments are allowed to collect funds and spend them in the course of their operations without being required to go through the lengthy and really unnecessary process of, first, paying those funds to the state treasury and, then, having them reallocated to the department by the treasury. Thus under MSSIC's construction of section 115, the crucial issue is whether the activity is an "essential governmental function", not whether there is a technical accrual to the state. Under the MSSIC construction of section 115, the determination that an activity is an essential governmental function strongly implies that the income derived accrues to the state.

This court accepts neither construction in its entirety. This court feels that the accrual requirement can only be interpeted in the light of the purpose of section 115. While no legislative history was cited by either party, it seems fair to say that the purpose of the exemption enacted in section 115(a)(1) was to insure that local governments, state, county, and municipal, would not be hampered in the performance of their functions by the imposition of federal income taxes. Thus construed, the determination that the section 115(a) exemption should be extended to a taxpayer requires a weighing of how central the activity sought to be taxed is to the operation of state government and of how directly taxation of the income of the activity will burden the state treasury. While the requirements of "essential governmental function" and "accrual" are not independent, either may be so lacking that test of section 115(a) is not met. This court holds that the accrual aspect of the test for section 115(a) exemption is so lacking. With MSSIC, the state has absolutely no financial obligations. At

no time will the reduction in accumulated earnings caused by federal taxation of MSSIC's income cause the state to pay anything out to MSSIC or its creditors. No state funds are part of the capital which produces MSSIC's income; all such funds are derived from member associations. Therefore, MSSIC's claim for exemption under section 115(a) fails for failure to meet the accrual test.

Alternatively, this court believes that the claim for exemption under section 115(a) fails because MSSIC does not meet the "essential governmental function" requirement of that section. MSSIC urges that those private corporations that have undertaken to provide the service MSSIC provides have either failed or been frauds and that the only corporations successfully performing the function are state or federal corporations. The states of Ohio and Massachusetts have such corporations as does the federal government in the Federal Savings and Loan Insurance Corporation. MSSIC thus concludes that it is performing an essential governmental function. The United States, on the other hand, points out that savings and loan associations in 47 other states operate with no such insurance program. The only case MSSIC cites construing the "essential governmental function" requirement is *Jamestown & Newport Ferry Co.* v. *C.I.R.*, 41 F.2d 920 (1st Cir. 1930). In that case the income of a ferry company was held to be immune from federal taxation under a predecessor to section 115(a). The entire capital stock of the ferry company was owned by the town of Jamestown, Rhode Island. The company operated ferries between the island in Narrangansett Bay on which the town was situated and the mainland. Deeming the ferry essential to the normal life of the community, the First Circuit decided the company's income should be ex-

empt from federal taxation. The court concluded that the ferry was not merely a matter of "public convenience". Without the facility the inhabitants of the island had no other means of access to the mainland. In that case, however, the corporation was financed by the town or by use of the town's credit. Thus the function was deemed sufficiently essential by the town to lay its money on the line and federal income taxes were being imposed on the earnings of the town's money. The state of Maryland has no such investment in MSSIC. Therefore, the *Jamestown & Newport Ferry Co.* is not determinative of the issue here.

MSSIC also cites intergovernmental tax immunity cases to establish that MSSIC's activity is an essential governmental function. The relationship between section 115(a) and the doctrine of intergovernmental tax immunity is not clear, however; so the applicability of those cases to the issue here is not clear. As noted briefly above, the apparent purpose of the section 115(a) exemption would seem to be the same as that of the immunity afforded under the implied constitutional principle of intergovernmental tax immunity, *i.e.*, to avoid overburdening state governments. It is not clear that the common purpose requires that the scope of the two exemptions need be identical, but that does seem a sensible result. Thus, this court feels the cases cited by MSSIC are to be contended with. Specifically, MSSIC cites cases determining that Army Post Exchanges and the American Red Cross are federal instrumentalities such that they should be immune from state taxation, *Department of Employment* v. *United States*, 385 U.S. 355 (1966) (Red Cross) and *Standard Oil Co.* v. *Johnson*, 316 U.S. 481 (1942) (Post Exchanges). MSSIC argues that the same factors relied upon by the Supreme

Court to determine that post exchanges and the Red Cross are instrumentalities of the federal government are present in this case and dictate that MSSIC be found an instrumentality of Maryland, performing an essential governmental function. As to post exchanges, the exchanges were created under regulations promulgated by the Secretary of War; money from dissolved exchanges is paid over to the federal government; Congress appropriates money for the construction of buildings for exchanges; the commanding officer of the post has authority to establish a post exchange; and profits of the exchange's operations go to activities designed to improve the pleasure and comfort of the troops. The federal government, however, assumes none of the financial obligations of the exchange. With the Red Cross, the organization was chartered by Congress; its principal officer is appointed by the President, as are seven of the 49 governors; the organization is under executive order to meet the country's obligations under various Geneva Conventions and to assist the Armed Forces; and the organization receives substantial material assistance from the federal government. Like those organizations, MSSIC was created by special legislative enactment; it operates in close conjunction with the State Department of Building, Savings and Loan Asociations in its routine activities; it operates under bylaws initially created by a board of directors appointed by the state and still must secure state approval of changes in the bylaws; and its accumulated income will escheat to the state upon dissolution. While many of the features are similar, there remain distinguishing features. With the post exchanges, the profits from the operations go to provide comforts for members of the armed forces; with the Red Cross, the federal government provides material assistance.

In both cases the federal government has a direct financial interest in the operation of the instrumentality. Maryland has no such direct interest in the operation of MSSIC. The cost of the insurance function is borne entirely by member associations. If the income of MSSIC is insufficient to meet its liabilities, the state does not step in to meet the obligation. Under these circumstances, this court concludes that MSSIC is not performing an "essential governmental function". Thus, MSSIC's claim for exemption under section 115(a) fails on this ground also.

MSSIC next asserts that it is immune from federal income taxation by reason of the doctrine of intergovernmental tax immunity. According to that doctrine, since the Constitution clearly envisions a federal system, it necessarily implies that the existence of either state or federal governments should not be subjected to the control of the other by means of an extra-constitutional technique like taxation. More succinctly, as was said in *M'Culloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316 (1819), the power to tax is the equivalent of the power to destroy. The doctrine has no express constitutional basis, however; it is merely "implied" from the constitutional framework. While MSSIC apparently asserts that a finding that MSSIC is a state "instrumentality" necessitates a finding that it is immune from federal taxation under the doctrine, it does admit that the purpose of the doctrine is only to leave the state free of "undue" interference. The United States comes down harder on this point and asserts that a "burden" test should be used to determine the applicability of the doctrine, citing *Willcuts* v. *Bunn*, 282 U.S. 216 (1931). In *Willcuts* v. *Bunn*, the Court analyzed the burden imposed upon the state by the taxation of the profit realized by an individual taxpayer upon the sale of state

bonds. Admitting that the burden imposed by taxation of the interest paid to the bondholder by the state would substantially affect the state, it concluded that the burden imposed by a tax on the profits of the private sale did not fall upon the state and denied the exemption of the income to the taxpayer. Such a "burden" analysis seems appropriate. Since the doctrine serves to protect the state from the imposition of taxes which unduly burden the state in the performance of its functions, immunity should be extended only to those situations where the state is actually hampered in its activity. The state of Maryland is not so "burdened" by the imposition of federal tax on the income of MSSIC. The sole source of the capital which produces the income taxes is the contribution by the private savings and loan associations which seek coverage. The state of Maryland makes no financial contribution to which the income may be attributed. Moreover, the state of Maryland has no present interest in the income which accumulates. It is only upon dissolution of MSSIC and escheat to the state that the income in question accrues to the state. Until that time accumulated income is applied to pay the expenses and to meet the liabilities of MSSIC. Under the circumstances, the tax cannot be said to impose a burden on the state of Maryland. Therefore, MSSIC's claim for a refund based on the doctrine of intergovernmental tax immunity fails.

Finally, MSSIC claims that to deny it exemption from federal income tax is a denial of due process under the Fifth Amendment in light of the fact that essentially identical corporations are exempt under INT. REV. CODE section 501(c)(14). Section 501(c)(14) provides that the following are included in the tax exemption provisions of section 501(a):

(B) Corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of, shares or deposits in—

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(iii) mutual savings banks not having capital stock represented by shares.

Since MSSIC was created after the September 1, 1957, cutoff date, it does not qualify for exemption even though it is otherwise within the requirements of the section. MSSIC asserts, however, that cutting off the exemption at September, 1957, is arbitrary and capricious and constitutes a denial of due process.

The law on the restrictions placed on the taxing power by the Fifth Amendment due-process requirement is aptly summarized in *Smart* v. *United States*, 222 F.Supp. 65, 67 (S.D.N.Y. 1963), *aff'd*, 332 F.2d 283 (2d Cir. 1964):

> In the case of the fifth amendment, although there is no equal protection clause, an arbitrary and unreasonable classification would constitute a violation of due process. Steward Machine Co. v. Davis, 301 U.S. 548, 57 S.Ct. 883, 81 L.Ed. 1279 (1937). It is therefore necessary to consider the reasonableness of the classification imposed here.
>
> The Supreme Court has held repeatedly that inequalities resulting from a singling out of a particular class for taxation or exemption do not infringe any constitutional limitation. The Con-

> gress may make distinctions having a rational basis, and "when subjected to judicial scrutiny they must be presumed to rest on that basis if there is any *conceivable state of facts* which would support it." Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 57 S.Ct. 868, 81 L.Ed. 1245 (1937).
>
> It has been said that Congress has the widest powers of selection and classification and that its use of these powers will be considered unreasonable only when the classification is so arbitrary as to have no reasonable basis. Abney v. Campbell, 206 F.2d 836 (5th Cir. 1953). (emphasis supplied)

MSSIC claims that the effect of section 501(c)(14) is to exempt two funds substantially identical to MSSIC, the Co-operative Central Bank (Massachusetts) and the Ohio Deposit Guaranty Fund. It asserts that there is no reasonable basis for the 1957 cutoff and that the cutoff is so discriminatory as to deny MSSIC due process.

MSSIC is essentially identical to the Ohio Deposit Guaranty Fund. Both are managed by a board of directors who are elected by the member associations. Three of the directors of MSSIC are appointed by the governor, while none of the directors of the Ohio corporation are chosen by the governor. Both funds are capitalized by the deposit by member associations of two percent of their outstanding accounts, which amount is adjusted semi-annually. Both rely on state regulatory agencies for reports of examinations of member associations. The Maryland corporation does differ in some respects. The Maryland corporation cannot accept a member unless it is first approved by the Maryland State Department of Building, Savings and Loan Associations. The Ohio fund can accept any applicant without such state approval. Changes

in the bylaws and regulations of the Maryland corporation must be submitted for state approval. Such changes in the Ohio fund are not supervised. While both funds are currently voluntary, membership in the Maryland corporation becomes mandatory for those not otherwise insured by 1973. The Maryland fund is specifically exempt from state taxation. The Ohio fund has no such exemption. Testimony indicated that, in all other respects, the operations of MSSIC and the Ohio fund are identical. Apparently the only difference between the two is the date of incorporation.

The legislative history of section 501(c)(14) does not reveal the reason the exemption was granted. Prior to 1951 the entire mutual savings bank and savings and loan industries were exempt under the Internal Revenue Code from tax on the income of their operations. In 1951 the decision was made that the purpose of the exemption, to afford savings institutions which had no capital stock the benefit of tax exemption so that a surplus could be accumulated to provide the depositors with greater security on their deposits, was no longer applicable. The industries had developed to the point where the ratio of capital account to total depositors was comparable to that of commercial banks, which did not have an exemption. Therefore, the exemption for the mutual banks and the savings and loan associations was discontinued. *See* S. REP. No. 781, 82d Cong., 1st Sess., 2 U.S. CODE CONG. & AD. NEWS 1991-97 (1951). While the exemption for the mutual banks and savings and loan associations was discontinued, the exemption for nonprofit corporations which insured those organizations was carried forward as section 501(c)(14). While the reason for discontinuing the exemption of mutual banks and savings and loan associations does appear

in the committee report, the reason for continuing the exemption for insurers does not appear. The exemption carried forward, however, was qualified by adding a cutoff date of September 1, 1951. Insurers not organized before that date did not qualify for the exemption. Revenue Act of 1951, ch. 521, sec. 313(b), 65 Stat. 490. In 1960 the cutoff date was changed from September 1, 1951, to September 1, 1957. Act of April 22, 1960, Pub. L. 86-428, section 1, 74 Stat. 54. Senate Report No. 1034 of the Committee on Finance, recommending that the cutoff be moved forward, indicates that the purpose for bringing the cutoff date forward was to enable the Ohio Deposit Guaranty Fund to qualify for the exemption. The report states the following:

> Under present law an exemption from income tax is provided for non-profit, mutual organizations having no capital stock which are operated for the purpose of providing reserve funds for, and insurance of, shares or deposits in domestic building and loan associations, cooperative banks, or mutual savings banks. However, in order to be exempt these organizations also must have been organized before September 1, 1951. * * *
>
> There are four such organizations now in existence: Two in Massachusetts, one in Connecticut, and one in Ohio. * * *
>
> * * * Three of the four private organizations providing essentially the same services for their members * * * are exempt because they were organized before September 1, 1951, the approximate time when the exemption for these organizations was added to the law. Because the guarantee organization in Ohio, although performing the same services, was organized after that date it is presently denied exemption.

> Your committee's bill corrects this discrimination by moving forward from September 1, 1951, to September 1, 1957, the date before which these guarantee funds must have been organized in order to obtain income tax exemption.

S. REP. No. 1034, 86th CONG., 2d Sess., 2 U. S. CODE CONG. & AD. NEWS 1873-74 (1966). In a letter from the office of the Secretary of the Treasury to the Finance Committee, favorably reporting on the bill changing the cutoff, an assistant secretary does note the reason the original cutoff was included in the 1951 version. Letter from Jay W. Glasmann to Harry F. Byrd, Jan. 20, 1960, 2 U.S. CODE CONG. & AD. NEWS 1874-75 (1960). The letter indicates that counsel for the two Massachusetts insurance organizations which gained an exemption under the bill drafted the original exemption provision and that they included a cutoff date so that it could be represented that the revenue effects of the bill would be limited. The United States points out that the reason the cutoff was brought forward to 1957 was that the 1951 attempt to remove the exemption for savings and loan associations was circumvented by the associations and that the loophole was only effectively closed by the Revenue Act of 1962. Given the fact that the Ohio corporation had, like the corporations organized before September 1, 1951, been organized during a period when the savings and loans themselves were essentially not taxed, it was only fair to extend the same exemption to the Ohio corporation that was enjoyed by those who were organized before the original attempt to tax the savings and loans. Thus the 1957 cutoff does serve to extend the exemption only to those who were organized at a time when the savings and loan associations were virtually not taxed. While the decision to cut off an exemption as

to all similarly situated corporations would be clearly within Congress' prerogative, the question presented here is whether due process requires Congress to choose between opening or closing the exemption for all nonprofit corporations similarly situated, rather than discriminating between them solely on the basis of date of incorporation when the sole purpose for that incorporation classification is to afford exemption to a few while securing the flow of revenue from others.

The Supreme Court has dealt with challenges to classifications made by Congress in the exercise of its taxing power. *See* Fernandez v. Weiner, 326 U.S. 340 (1945), Heiner v. Donnan, 285 U.S. 312 (1932), Blodgett v. Holden, 275 U.S. 142 (1927), *modified*, 276 U.S. 594 (1928), Nichols v. Collidge, 274 U.S. 531 (1927), National Paper & Type Co. v. Bowers, 266 U.S. 373 (1924), Barclay & Co. v. Edwards, 267 U.S. 442 (1924), Brushaber v. Union P.R.R., 240 U.S. 1 (1916). None of these cases is analogous, however. Of those cases, only three actually held the classification in question to be so arbitrary as to constitute a denial of due process. *Nichols* v. *Coolidge*, 274 U.S. 531 (1927) and *Blodgett* v. *Holden*, 275 U.S. 142 (1927) both deal with the problem of the propriety of taxing a transfer not subject to taxation at the time it was made. In *Nichols* v. *Coolidge*, the transfer was a conveyance of real property, a gift, made in 1917 but, due to the retention of possession, arguably not completed until the grantor's death in 1921. The tax on the gift as a transfer made at death under a statute passed in 1919 was declared to violate due process. *Blodgett* v. *Holden* involved the question of taxing a gift made in January, 1924, under a statute passed in June, 1924, providing for the taxation of all such transfers made during 1924

and thereafter. The tax was held to violate due process. *Heiner* v. *Donnan*, 285 U.S. 312 (1932), held that the conclusive presumption that transfers without consideration and made within two years of the death of the donor were "in contemplation of death" and therefore subject to taxation under the estate tax violated due process. *Fernandez* v. *Weiner*, 326 U.S. 340 (1945), held that taxing community property as if it were entirely the property of the husband was not so arbitrary as to violate due process because the effect of the classification was that the tax burden placed on citizens of community-property states more nearly resembled that placed on citizens of non-community-property states. *Brushaber* v. *Union P.R.R.*, 240 U.S. 1 (1916), involved an attack on the progressive feature of the income tax on individuals, on various features of tax on the interest on corporate indebtedness, on the limitation on the deduction permitted for interest paid by a corporation, on the denial to corporations of the deduction of dividend income enjoyed by individuals, on distinctions between single and married taxpayers, and on the failure to impute income to homeowners on the rental value of their homes. The Court found that there were adequate bases for the classifications attacked. Similarly, there was an adequate basis for the distinction between foreign and domestic corporations with respect to sales in foreign countries, which was in issue in *National Paper & Type Co.* v. *Bowers*, 266 U.S. 373 (1924). The same distinction was involved in *Barclay & Co.* v. *Edwards*, 267 U.S. 442 (1924). Thus, while the proposition that the Fifth Amendment restricts the exercise of the taxing power seems firmly established, there are no Supreme Court cases dealing with the application of the prin-

ciple to a "grandfather clause" like that involved here.

The United States claims that date of incorporation is an appropriate basis for classification. It asserts that MSSIC might have a valid due process claim if it had been in existence at the time the exemption was granted and had been denied the exemption at the same time it was extended to others. It argues, however, that, that not being the case, the classification on the basis of date of incorporation is within the latitude permitted Congress. MSSIC argues to the contrary citing *Mayflower Farms* v. *Ten Eyck*, 297 U.S. 266 (1936). That case dealt with the problem of a discrimination based on date of organization and found it to be a denial of equal protection under the Fourteenth Amendment. In *Mayflower Farms*, a New York Milk Control Act went into effect for one year on March 31, 1933. Mayflower Farms entered the business as a milk dealer in the fall of 1933. The act regulated the price at which milk could be sold. It distinguished between brands which were "well advertized" and those which were not. Dealers not having a well advertized brand could sell one cent per quart below the price charged by dealers having well advertized brands. In 1934 when the act was renewed, the advantage of selling at one cent below advertized brand price was denied to any dealer who was not in business as of April 10, 1933. In the absence of a showing of the reason for the classification, the Court held it to be a denial of equal protection. The *Mayflower Farms* case, while dealing with a date of organization classification, contains the added fact that the organization was in existence at the time the discriminatory classification was made. As the United States points out, that element is not present in MSSIC's case. Moreover, the

question of the relative scope of the Fifth Amendment "due process" with respect to Fourteenth Amendment "equal protection" is raised when one seeks to apply the principle therein to the present case. While the United States is correct in its assertion that *Mayflower Farms* v. *Ten Eyck* is distinguishable on those grounds, this court is impressed with the fact that a cutoff date in a legislative enactment was subjected to judicial scrutiny and found to be a denial of equal protection.

In summary then, the situation is this. Congress has granted a tax exemption to a few mutual, nonprofit insurers of savings and loan associations and denied that exemption to substantially identical corporations. Functionally those corporations would seem to constitute a single class. Congress, however, has divided them into two classes. Those created before 1957 are of a class that is not taxed; those created after that date are of a class that is taxed. It is clear that Congress, having created a tax exemption as to an otherwise taxable entity, can remove that exemption whenever it wishes and that no showing of a reason other than the desire to obtain revenue would be required by this court before it would uphold Congress' action. However, even in matters which are clearly within Congress' prerogative, distinctions which are drawn must have a rational basis. No reason whatsoever, much less a reasonable one, appears for the discrimination between members of the class of mutual, nonprofit insurers created before 1957 and those created after 1957; nor can this court find any conceivable basis in fact for that discrimination. If there were, for example, a regulatory purpose incidental to the revenue purpose of section 501 (c)(14), then this court would uphold Congress' action; but no such regulatory purpose appears. In a letter to Wilbur D. Mills, chairman of the House

Ways and Means Committee, stating the Treasury's position on a bill which would have moved the cutoff date in section 501(c)(14) forward to 1963 and thus afforded exemption to MSSIC, the Assistant Secretary, Stanley S. Surrey, concluded, as this court concludes, that "Since organizations performing functions similar to those to be performed by the Maryland Savings-Share Insurance Corporation are now tax exempt, considerations of nondiscrimination may warrant extending the exemption to the Maryland Corporation." Letter from Stanley S. Surrey to Wilbur D. Mills, Aug. 3, 1962, attached to the complaint as exhibit "C". This court concludes that cutting off the exemption at the 1957 date is arbitrary and a denial of the Maryland Savings-Share Insurance Corporation's right to due process.

Accordingly, the clerk will enter a judgment in favor of the Maryland Savings-Share Insurance Corporation against the United States in the sum of $40,898.02 together with interest as provided by law.

/s/ Edward S. Northrop
United States District Judge

APPENDIX B

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

Civil Action File No. 19330

MARYLAND SAVINGS-SHARE INSURANCE CORPORATION

vs.

UNITED STATES OF AMERICA

JUDGMENT

This action came on for trial before the Court, Honorable Edward S. Northrop, United States District Judge, presiding, and the issues having been duly tried and a decision having been duly rendered,

It is Ordered and Adjudged that the Plaintiff, Maryland Savings-Share Insurance Corporation, recover of the Defendant, the United States of America, the sum of Forty Thousand Eight Hundred and Ninety-Eight Dollars and Two Cents ($40,898.02), together with interest as provided by law, and the costs of action.

Dated at Baltimore, Maryland, this 22nd day of January, 1970.

/s/ Paul R. Schlitz
Clerk of Court

I hereby attest and certify on 30 January 1970 that the foregoing document is a full, true and correct copy of the original on file in my office and in my legal custody.

Paul R. Schlitz
Clerk, U.S. District Court
District of Maryland

By Marilyn D. Figiel
Deputy

APPENDIX C

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 115. Income of states, municipalities, etc.

(a) *General Rule.*—Gross income does not include—

(1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or Territory, or any political subdivision thereof, or the District of Columbia; or

(2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

* * * *

SEC. 501. Exemption from tax on corporations, certain trusts, etc.

(a) *Exemption from Taxation.*—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502, 503, or 504.

* * * *

(c) *List of exempt organizations.*—The following organizations are referred to in subsection (a): * * *

(14)(A) Credit unions without capital stock organized and operated for mutual purposes and without profit.

(B) Corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and

without profit for the purpose of providing reserve funds for, and insurance of shares or deposits in—

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(iii) mutual savings banks not having capital stock represented by shares.

(C) Corporations or associations organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for associations or banks described in clause (i), (ii), or (iii) of subparagraph (B); but only if 85 percent or more of the income is attributable to providing such reserve funds and to investments. This subparagraph shall not apply to any corporation or association entitled to exemption under subparagraph (B).

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APPENDIX D

S. Rep. No. 1034, 86th Cong., 2d Sess., pp. 3-4.

OFFICE OF THE SECRETARY OF THE TREASURY
Washington, January 20, 1960.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

MY DEAR MR. CHAIRMAN: This is in response to a request for the views of this Department on H.R. 6155, to amend the Internal Revenue Code of 1954 to exempt from taxation certain nonprofit corporations or associations organized after August 31, 1951.

Section 501(c)(14) exempts from income tax corporations or associations without capital stock organized before September 1, 1951, and operating on a mutual nonprofit basis to provide reserve funds for, or the insurance of, shares or deposits in domestic building and loan associations, cooperative banks, and mutual savings banks. H.R. 6155 would extend the exemption to similar corporations or associations organized before September 1, 1957. The amendment would apply to taxable years beginning after December 31, 1958.

Present section 501(c)(14) originated in section 313 of the Revenue Act of 1951 which eliminated the exemption from tax previously accorded to domestic building and loan associations, cooperative banks, and mutual savings banks. It was added in conference. In its consideration of the Technical Amendments Act of 1958 (H.R. 8381), the Senate adopted a floor amendment (No. 8-5-58-D) identical to that contained in section 1 of H.R. 6155. That amendment was opposed by this Department on the ground there was insufficient time to examine the specific organizations involved and to determine whether there was a basic

reason for the original date limitation. The amendment was dropped in conference.

It is understood that H.R. 6155 was introduced at the instance of the Ohio Deposit Guaranty Fund, a mutual deposit guarantee association which was organized on December 6, 1956, under an Ohio statute which became effective on October 12, 1955. The fund was organized exclusively for the purpose of assuring the liquidity of and guaranteeing the deposits in domestic building and loan associations in Ohio. According to advice given the Department, the fund's membership consists of more than 100 building and loan associations of which some 90-odd are located in Hamilton County, Ohio.

In the past the fund has unsuccessfully sought tax-exempt status administratively and through legislation. On June 25, 1958, its application for exempt status was denied by the Internal Revenue Service because it was organized subsequent to August 31, 1951. Amendment No. 8-5-58-D, previously referred to, was introduced by Senator Bricker.

It has been brought to the Department's attention that the predecessor of section 501(c)(14) was added to the Revenue Act of 1951 at the behest of two mutual deposit guarantee funds in Massachusetts. Such provision was drafted by counsel for those organizations who state that the 1951 cutoff date was included solely so that it could be represented that the revenue effects would be limited to the two Massachusetts funds, a fund in Connecticut and one in New Hampshire. The latter fund is no longer in existence.

Under the circumstances described above it would seem difficult to deny exemption from tax for the Ohio Deposit Guaranty Fund while the few existing similar organizations are exempt from tax. Accord-

ingly, the Department would not object to enactment of the bill.

It should be noted that the relief provided by the bill as passed by the House in 1959 would apply with respect to taxable years beginning after December 31, 1958. In order to remove retroactive application, the effective date of relief provided by the bill should be changed to taxable years beginning after December 31, 1959.

The Bureau of the Budget has advised the Treasury Department that there is no objection to the presentation of this report.

Sincerely yours,

JAY W. GLASMANN,
Assistant to the Secretary.

APPENDIX E

Hearing before the Senate Committee on Finance on H.R. 3297, 88th Cong., 2d Sess., pp. 9-10.

STATEMENT ON H.R. 3297 BY JOSEPH P. MCMURRAY, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. Chairman and members of the committee, I have been asked to present the views of the Federal Home Loan Bank Board on H.R. 3297, which was passed by the House of Representatives and is now pending before your committee.

Under present law, section 501(c)(14) of the Internal Revenue Code of 1954, as amended, an exemption from Federal income tax is provided for nonprofit, mutual organizations which have no capital stock and are operated for the purpose of providing reserve funds for, and insurance of share or deposits in, domestic building and loan associations, cooperative banks, or mutual savings banks. However, under said section of the Internal Revenue Code, the exemption from income tax applies only to organizations organized prior to September 1, 1957. H.R. 3297 would change the September 1, 1957, date to January 1, 1963, with the effect, as stated in the House committee report accompanying H.R. 3297, that the recently organized Maryland Savings-Share Insurance Corp., would be entitled to income tax exemption.

The Federal Home Loan Bank Board recognizes that a major consideration as to whether H.R. 3297 should be enacted into law is its effect on the tax structure. The Federal Home Loan Bank Board expresses no view in that regard, but does believe that there is another factor which should be taken into consideration by the committee.

Both the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation were established by Congress to insure accounts in financial institutions. The objectives of the Maryland Savings-Share Insurance Corp., and other State-authorized account insurance programs, are in large measure the same as the objectives of FDIC and FSLIC and this is essentially the ground stated in House Report No. 459 for the favorable report by the House Committee on Ways and Means.

Considering its responsibilities with respect to the Federal Savings and Loan Insurance Corporation, the Federal Home Loan Bank Board is of the opinion that the interests of the United States are not served by a policy of bestowing tax exemption on various State-chartered insurance schemes for financial institutions, which frequently serve as substitutes for the more rigorous standards of Federal account insurance and may be accepted by the public as roughly comparable. They are not in fact equivalent. Although the capital stock of FSLIC has been retired, the United States has a financial interest in the FSLIC through the authorization in section 402(i) of the National Housing Act, as amended, for it to borrow from the Treasury up to $750 million outstanding at any one time.

The enactment of H.R. 3297 may encourage the formation of other State-authorized insurance corporations which would reasonably expect similar income tax treatment and the Board does not favor encouraging the proliferation of such corporations. The Board's reasons for this position may be summarized as follows:

First, financial institutions have broad interdependence and failure of any State-authorized insurance fund may have adverse repercussions on FSLIC

and institutions insured by it. The United States has an interest in the financial stability of FSLIC and institutions insured by it because of their relationship to the general economic health of the Nation.

Second, as a broad generality, savings and loan associations which are not insured by FSLIC represent the smaller and, in many instances, weaker classes of associations. Thus, they are not as well equipped to compete and are more apt to fail under economic stress than those insured by FSLIC. It would follow that the strain on State-authorized insurance funds, with less risk diversification, would be greater than in the case of FSLIC.

Third, because of disparities in face amount of insurance, State-authorized insurance programs for savings and loan associations may be established and used as competitive devices in a manner inconsistent with the objective of insurance of accounts to promote stability. For example, the Maryland statute (art. 23, sec. 161SS) states that the insured limit "may not *exceed* by more than the sum of $10,000 the amount of prevailing insurance available from the FSLIC or its successor instrumentality from time to time." [Italic supplied.] Accordingly, Maryland associations that are members of the Savings-Share Insurance Corp. could advertise accounts insured up to $20,000.

Fourth, a State-authorized insurance fund could be essentially privately operated without any real public control over it. For example, while the Maryland law envisions an exchange of information concerning insured associations between the State supervisor and the Maryland Savings-Share Insurance Corp., no provision is made in the statute for independent examination of, or other control over, the insured associations by the State-authorized insurance corporation. The directorship of the corporation in Maryland will

be largely composed of representatives of member insured associations. No provision is made in the Maryland statute for termination of insurance where an institution is pursuing an unsound course.

In essence, the Board's objection to encouragement by the United States, through grant of Federal tax exemption, of proliferation of State-authorized insurance funds is that such State funds can reap the benefit of conditioning of the public to insurance of accounts in savings and loan associations by FSLIC, and thus gain public acceptance. At the same time, such State funds may not have the safeguards and diversification of risk of FSLIC. The likelihood of failure may be greater for such State funds than in the case of FSLIC, with possible adverse repercussions on FSLIC because of association in the public mind.

It is understood that your committee is also considering an amendment to H.R. 3297, which amendment is designed to extend to the New York State Savings & Loan Bank the exemption from income tax provided by section 501(c)(14) of the Internal Revenue Code. While the Federal Home Loan Bank Board has not had opportunity to study this matter at any length, my immediate impression is that the reasons assigned for recommending against extension of the tax exemption to State corporations engaged in insuring accounts are not as applicable to a State corporation designed to supplement the type of assistance provided savings and loan associations by Federal home loan banks.

It is understood that the Savings & Loan Bank of New York maintains a liquidity fund to make loans to New York savings and loan associations which are short of liquid assets. Broadly speaking, the same function is performed by Federal home loan banks

for their members. An operation such as the Savings & Loan Bank of New York, so long as it is not regarded as a substitute for the Federal Home Loan Bank System, would simply represent a supplementary means of meeting liquidity needs of savings and loan associations. That the operation of the New York Savings & Loan Bank is supplemental to and not in substitution for the Federal Home Loan Bank System is borne out by the fact that nearly all of its members, it is understood, are also members of the Federal Home Loan Bank System. The Board, therefore, does not object to this amendment.

Advice has been received from the Bureau of the Budget that there is no objection, from the standpoint of the administration's program, to the submission of this report.

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IN THE

Supreme Court of the United States

OCTOBER TERM, [redacted] 1970

No. [redacted] 160

UNITED STATES OF AMERICA,

Appellant,

v.

MARYLAND SAVINGS-SHARE INSURANCE CORPORATION,

Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

MOTION TO AFFIRM

RICHARD W. CASE,
1700 One Charles Center,
Baltimore, Maryland 21201,
Counsel for Appellee.

Of Counsel:

P. DENNIS BELMAN,
1700 One Charles Center,
Baltimore, Maryland 21201.

The Daily Record Co., Baltimore, Md. 21203

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1969

No. 1575

UNITED STATES OF AMERICA,

Appellant,

v.

MARYLAND SAVINGS-SHARE INSURANCE CORPORATION,

Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

MOTION TO AFFIRM

Appellee moves, pursuant to Rule 16 of the Rules of the Supreme Court of the United States, that the final judgment of the United States District Court for the District of Maryland be affirmed on the ground that the questions presented are so unsubstantial as not to warrant further argument.

QUESTIONS PRESENTED

1. Whether the district court was correct in excising the cutoff date from Section 501(c)(14)(B) of the Internal Revenue Code of 1954 because it created an arbitrary and unreasonable discrimination as applied to Maryland Sav-

ings-Share Insurance Corporation and was, therefore, a denial of its right to due process in contravention of the Fifth Amendment.

2. Whether the district court erred in holding that Maryland Savings-Share Insurance Corporation is not a State instrumentality immune from Federal income taxation.

3. Whether the district court erred in holding that the exemption from Federal income taxation afforded by Section 115(a)(1) of the Internal Revenue Code of 1954 is not applicable to the income of Maryland Savings-Share Insurance Corporation.

STATUTES INVOLVED

INTERNAL REVENUE CODE OF 1954

Sec. 115. Income of states, municipalities, etc.

(a) *General Rule.* — Gross income does not include—

(1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or Territory, or any political subdivision thereof, or the District of Columbia; or

(2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

* * * * * * *

Sec. 501. Exemption from tax on corporations, certain trusts, etc.

(a) *Exemption from Taxation.* — An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under sections 502, 503, or 504.

* * * * * *

(c) *List of exempt organizations.* — The following organizations are referred to in subsection (a): * * *

(14)(B) Corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of shares or deposits in—"

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(iii) mutual savings banks not having capital stock represented by shares.

STATEMENT

Maryland Savings-Share Insurance Corporation ("MSSIC") is a non-stock, non-profit corporation specially chartered in 1962 by an Act of the General Assembly of Maryland. Md. Ann. Code art. 23, §§161MM-AAA. MSSIC was the second part of a State program designed to eliminate the patently fraudulent abuses prevalent in the Maryland savings and loan industry in the late 1950's and early 1960's, abuses which resulted in the loss of approximately twenty-five million dollars to shareholders in Maryland savings and loan associations. Its birth was the Maryland legislature's response to a finding of two Executive Commissions that "no existing private corporation . . . could adequately insure the deposits" of savings and loan associations which did not qualify for insurance by the Federal Savings and Loan Insurance Corporation (Jurisdictional Statement, App. A, p. 16).

Membership in MSSIC is limited to associations organized under the laws of Maryland or authorized to do business therein, organized for the purpose of accepting free-share accounts and making loans to their members, and approved by the State Department of Building, Savings and Loan Associations. Md. Ann. Code art. 23, §§161A(e), 161PP, 161WW. It is governed by an eleven member board of directors, three of whom are appointed by the Governor. Md. Ann. Code art. 23, §§161-OO. Its by-laws, rules, and regulations cannot be amended without the prior approval of the Director of the State Department of Building, Savings and Loan Associations. Md. Ann. Code art. 23, §161SS.

All member associations of MSSIC must deposit two percent of their free-share accounts with MSSIC; and these deposits, together with income earned thereon, form the capital of the central insurance fund (Jurisdictional Statement, App. A, p. 16). Such income is exempt from taxation by the State of Maryland, and all of its political subdivisions, and can never be returned to member associations. Md. Ann. Code art. 23, §§161XX, 161NN(c).

MSSIC brought action in the court below to recover $40,898.02 (together with interest) paid by it to the United States Treasury Department, Internal Revenue Service, District Director, Baltimore, Maryland.[1] MSSIC argued below that its income is exempt from taxation under Section 115(a)(1) of the Internal Revenue Code of 1954 (the "Code"); that its income is immune from Federal taxation under the doctrine of intergovernmental tax immunity; and that it is entitled to the exemption from Federal income taxation provided by Code Section 501(c)(14)(B) as a

[1] Taxes were paid by MSSIC between October 6, 1964, and June 1, 1967, in the amounts and for the taxable periods as set forth in Appellant's Jurisdictional Statement, p. 3 n.1.

matter of due process of law (Jurisdictional Statement, App. A, p. 17).

The district court held that the cutoff date in Code Section 501(c)(14)(B) "is arbitrary and a denial of Maryland Savings-Share Insurance Corporation's right to due process", excised the cutoff date from the section, and ordered entry of judgment for MSSIC in the amount of $40,898.02, together with interest as provided by law (Jurisdictional Statement, App. A, p. 35). This is a direct appeal from such decision pursuant to 28 U.S.C. §1252.

ARGUMENT

The decision below is so manifestly correct as not to warrant further argument before it as affirmed. The issue in the case is uniquely narrow; and the decision, if affirmed, would apply only to the Appellee herein.[2] Appellant contends that the rationale of the lower court's decision "draws into question the power of Congress to limit exemptions from tax through the use of 'grandfather clauses,' and otherwise to make tax classifications on the basis of the dates of occurrence of transactions or other events" (Jurisdictional Statement, p. 5).

Appellant's position does not bear scrutiny. The case in no way touches upon the Congressional power to create reasonable classifications by cutoff dates, nor its power to change prospectively the applicability of any provision of the Code. Rather, the only issue is whether Congress is empowered to classify without a reasonable basis. Appellee does not question Congress' vast power to classify

[2] Appellant has admitted that the decision applies only to MSSIC and the North Carolina Savings Corporation. Appellee has no information with respect to this North Carolina corporation; and, therefore, it can not determine whether the lower court's decision is applicable to such corporation.

for tax purposes or to discriminate, if reasonable, between classes of taxpayers. Likewise, the court below recognized that the statute would not violate any concept of due process but for the absence of "any conceivable basis in fact for that discrimination" (Jurisdictional Statement, App. A, p. 34).

Moreover, Appellant cites several sections of the Code containing cutoff dates as indicative of the far-reaching effects of the decision below. However, none of these sections, save one,[3] classify for tax purposes *on the basis of the date of birth of a taxpayer*, as does Code Section 501 (c)(14)(B).

The reasonableness of the classification in Code Section 501(c)(14)(B) alone, and not the power of Congress to make classifications *on the basis of the dates of occurrence of transactions or other events*, has been drawn into question by the court below.

I.

THE CUTOFF DATE CREATES AN UNREASONABLE CLASSIFICATION

Notwithstanding Congress' extraordinary powers granted it by the Sixteenth Amendment, the taxing powers, as all others, are constitutionally limited by substantive due process. See *Galvan v. Press*, 347 U.S. 522, 530 (1954). Thus Congress may not under the guise of its taxing powers create a classification between taxpayers that lacks any reasonable basis. *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1, 24-25 (1916). A classification is arbitrary and unreasonable if its only purpose is an impermissible one,

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[3] Code Section 501(c)(14)(C) has a cutoff date identical to the one questioned by the lower court. That section deals with an exemption for corporations similar to MSSIC if created on or before September 1, 1957.

i.e., beyond the scope of Congress' powers. See *Yick Wo v. Hopkins*, 118 U.S. 356, 374 (1886).

The only purpose advanced in support of the classification created by the cutoff date in Section 501(c)(14)(B) is, in essence, the protection of the interests of the Federal Savings and Loan Insurance Corporation ("FSLIC") (Jurisdictional Statement, pp. 9-10).[4] But the direct objective of the cutoff date in furtherance of this alleged purpose is to deter the formation of state mutual insurers. This direct objective alone must support the classification.

While it is Congress' prerogative to protect FSLIC, such protection cannot be achieved by methods beyond the scope of its powers. See *M'Culloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 423 (1819). Congress may not deter the formation of state mutual insurers in order to protect the interests of their federal counterpart. See *Hopkins Federal Savings & Loan Association v. Cleary*, 296 U.S. 315 (1935). Since the only purpose advanced in support of the classification is the protection of FSLIC and since this purpose is an impermissible one, it follows that the cutoff date is "so arbitrary and capricious" that it must "fall within the ban of the due process clause of the Fifth Amendment." *Heiner v. Donnan*, 285 U.S. 312, 330 (1932).

Appellant contends that the district court's holding is inconsistent with this Court's decision in *O'Malley v. Woodrough*, 307 U.S. 277 (1939). That case is not controlling here. In *Woodrough* this Court upheld an income tax on the salaries of all Federal judges taking office after June

[4] Appellant's assertion that protection of FSLIC was the Congressional purpose for classification is based on a statement of the Chairman of the Federal Home Loan Bank Board in hearing before the Senate Committee on Finance on H.R. 3297, 88th Cong., 2d Sess. This statement is not of record in the court below and is, therefore, not properly before this Court. *Cf., South Carolina v. Wesley*, 155 U.S. 542, 544 (1895).

6, 1932, the date of the original enactment of the taxing statute. Congress, however, had a reasonable basis for its classification in that case. Indeed, the classification was constitutionally compelled since this Court had previously held in *Evans v. Gore*, 253 U.S. 245 (1920) that an income tax imposed on the salary of a Federal judge after his taking office was an unconstitutional diminution of his compensation while in office.

This Court's discussion in *Woodrough* that the judge had notice of the tax when he took office relates only to the fact that his salary never decreased while he was in office. *Woodrough* does not represent a judicial sanction of the use of a "grandfather clause" for all possible situations. Rather, this Court recognized the validity of a classification created by a cutoff date when it is supported by a reasonable purpose.[5]

Mayflower Farms, Inc. v. Ten Eyck, 297 U.S. 266 (1936), although involving the equal protection clause of the Fourteenth Amendment, is illustrative of a classification generated by a cutoff date that was found by this Court to be wholly lacking a reasonable basis. Contrary to Appellant's interpretation of *Mayflower* (Jurisdictional Statement, p. 11), the independent milk dealer claiming an unreasonable discrimination did not come into existence until the autumn of 1933, thus *after* the cutoff date of April 10, 1933, had been established by the Milk Control Act of 1933 (its effective date). The 1934 Act, under which the dealer was denied a license, merely re-enacted the original cutoff date. The dealer was denied the license because it had violated the 1933 Act (under which its original license was granted) by taking advantage of the price differential. *Id.* at 270-72.

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[5] Likewise, in every other case upholding a cutoff date cited by Appellant (Jurisdictional Statement, p. 12 n.9), there existed a reasonable basis for the distinction.

Therefore, the dealer, as did MSSIC, came into existence after the cutoff date had been enacted, *a factor not seized upon by this Court to deny relief from an unreasonable classification.* Furthermore, this Court rested its decision not on the fact that the statute would put an existing dealer out of business, but rather upon the fact that it impeded the formation of new independent milk dealers. *Id.* at 273.

The only purpose for the discrimination in *Mayflower* was found by this Court to be unreasonable since it was "but an attempt to give an economic advantage to those engaged in a given business at an arbitrary date as against all those who enter the industry after that date." *Id.* at 274. This Court's discussion of economic advantage there related to the unreasonable nature of the cutoff date in the Milk Control Act and did not purport to represent the only test of reasonableness. However, even were this the exclusive test as Appellant contends, we submit that the standard is met in this case. In *Mayflower*, the economic advantage accruing to dealers in existence at the cutoff date was an opportunity for increased income due to the competitive advantage gained by using the price differential. Likewise, Section 501(c)(14)(B) affords those state mutual insurers organized before September 1, 1957, the economic advantage of increased income because they need not pay income taxes.

Appellee recognizes its burden to negate every conceivable basis which might support the classification created by the cutoff date. *Madden v. Kentucky*, 309 U.S. 83, 88 (1940). Appellee cannot find, nor has Appellant suggested, any conceivable basis, save an unreasonable one, to support this classification. We submit, therefore, that this burden has been satisfied.

II.

THE CUTOFF DATE WAS PROPERLY EXCISED

Appellant contends that the lower court, even if correct in holding that Code Section 501(c)(14)(B) unconstitutionally discriminates against MSSIC, was nonetheless in error in excising only the cutoff date from the statute. Appellant's argument to support this conclusion reveals its fallacy.

Appellant states that the exemption was enacted "only after Congress received assurances that the exemption would be available only to the four mutual insurers then in existence" and that "it regarded the cutoff date as vital" to the enactment of the exemption (Jurisdictional Statement, pp. 8, 13). Therefore, we are told, the cutoff date is inseparable from the statute; and hence the whole section must fall.

The Revenue Act of 1951 eliminated the exemption from income taxation previously afforded the entire savings and loan industry, but retained an exemption for non-profit mutual insurers organized before September 1, 1951 (c. 521, 65 Stat. 452, 490). The legislative history of the 1951 Act discloses *no* reason for the insertion of the cutoff date. Appellant, however, in an attempt to fill this historical void, directs us to a letter written by the Assistant to the Secretary of the Treasury to the Chairman of the Senate Finance Committee nine years after passage of the 1951 Act (Jurisdictional Statement, p. 8 and App. D, pp. 41-43).[6]

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[6] The pertinent portion of the letter from Assistant Secretary Glassman to Senator Byrd, is as follows:

> It has been brought to the Department's attention that the predecessor of Section 501(c)(14) was added to the Revenue Act of 1951 at the behest of two mutual deposit guarantee funds in Massachusetts. Such provision was drafted by counsel for those organizations who state that the 1951 cutoff date was included solely so that it could be represented that the revenue

Initially we note that a statement found in the legislative history of a bill to amend an existing statute should have no probative value in determining the intent of a prior Congress. Especially is this so when the statement relied upon is wholly undocumented and attributable to nothing in the record of proceedings relating to the passage of the 1951 Revenue Act. Moreover, nowhere in the letter can there be found any language indicating that the cutoff date was a prerequisite to enactment of the exemption. Indeed, it appears that the counsel for the Massachusetts funds who drafted the provision gratuitously inserted the cutoff date therein. It is submitted that the legislative history of Section 101(4) of the Internal Revenue Code of 1939 (the predecessor of present Code Section 501(c)(14)(B)) indicates that Congress' primary purpose was to preserve the exemption from taxation for non-profit insurers of shares or deposits in savings and loan associations. What other reason could there have been for Congress to carve out this limited exception from its announced goal of eliminating the exemption theretofore available to the entire savings and loan industry?[7]

Obviously, Congressional intent to limit the exemption to those mutual insurers created before September 1, 1951,

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effects would be limited to the two Massachusetts funds, a fund in Connecticut and one in New Hampshire. The latter fund is no longer in existence.

(Jurisdictional Statement, App. D, p. 42).

[7] Appellant mistakenly states that the 1951 Act was applicable to "existing organizations formed in reliance on the exemption" (Jurisdictional Statement, p. 8). Prior to 1951 all savings and loan associations, *as well as* non-profit insurers thereof, were exempt from taxation. The 1951 Act did not preserve this exemption for all those associations formed prior to 1951, but only for those non-profit *insurers* of savings and loan accounts in existence before that date. Indeed, had the 1951 Act retained an exemption for all savings and loan associations created prior to its effective date, the constitutionality of the Act would have been questioned long before the present action was brought.

if any such intent were present, was subordinate to its clear desire to exempt from taxation generally a small segment of the savings and loan industry, *i.e.*, mutual insurers. A holding that all of Code Section 501(c)(14)(B) must fall would only frustrate this overriding legislative purpose. See Int. Rev. Code of 1954, §7852(a); *Utah Power & Light Co. v. Pfost*, 286 U.S. 165, 184-85 (1932); *Champlin Refining Co. v. Corporation Commission*, 286 U.S. 210, 234-35 (1932); *Carter v. Carter Coal Co.*, 298 U.S. 238, 334-35 (1936).

III.

MSSIC IS A STATE INSTRUMENTALITY IMMUNE FROM TAXATION

Alternatively, Appellee asks this Court to review the lower court's determination that MSSIC's income is neither immune from Federal income taxation nor exempt therefrom pursuant to Code Section 115(a)(1). See *United States v. Raines*, 362 U.S. 17, 27 n.7 (1960).

MSSIC was created by a statutory charter and was designed to effect a marriage between the Maryland government and the private building, savings and loan industry — something that could only be accomplished through a special legislative act. See Md. Const. art. III, §48. It was created to prevent a recurrence of the financial diaster which previously had befallen many of the State's citizens (see p. 3, *supra*, and Jurisdictional Statement, App. A, p. 16).

The charter provides for strict State control of MSSIC's organization and management, thus removing the possibility that the private industry could ever alter its structure at the expense of public investors in member associations.[8] We submit that MSSIC from its very inception

[8] See, *e.g.*, the following sections of MSSIC's Charter: Md. Ann. Code art. 23, §§161NN(c) (investment income can not be returned

was designed to be an instrumentality of the State. Its statutory charter can leave no doubt on this score.

Moreover, available judicial authority amply supports our position. This Court in *Standard Oil Co. of California v. Johnson*, 316 U.S. 481 (1942) and in *Department of Employment v. United States*, 385 U.S. 355 (1966) held that Army post exchanges and the Red Cross, respectively, were instrumentalities of the United States and were, therefore, immune from state taxation. In both cases this Court's determinations rested upon factors present here. MSSIC, like the Red Cross and post exchanges, was created by statute; its governing authority has public representation; and its income belongs to the State, subject to being used for the benefit of investors in State-based savings and loan associations.

Furthermore, Maryland has a direct interest in MSSIC's operations and financial success. Were it not in existence, the investing public would be subject to the same hazards that evoked its creation. Maryland has prohibited MSSIC's income from being returned to member associations and has granted it an exemption from all State taxation. Md. Ann. Code art. 23, §§161NN(c), 161XX. Thus the legislature devised a scheme whereby the Maryland citizenry is assured that monies will be available when necessary. That such monies are not coming from the State's own treasury is immaterial. Had Maryland, for example, created a State agency with which State savings and loan associations not otherwise insured might deposit a percentage of their free-share accounts, the immunity from taxation of income

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to member associations), 161-OO (providing for public members, appointed by the Governor, on the board of directors), 161PP (State agency approval is a prerequisite to MSSIC membership), 161SS (State agency approval of any changes in the by-laws, rules and regulations is required).

earned thereon would be unquestioned. *Cf., Metcalf v. Mitchell*, 269 U.S. 514 (1926). Maryland has done precisely this, but instead through an intermediate governmental corporation, *i.e.*, MSSIC.

The burden imposed upon Maryland by the exaction of the income tax is equally clear. The Maryland General Assembly wanted — indeed demanded — that some provision be made for protection of innocent depositors in savings and loan associations. In lieu of direct State financial assistance, the present system was adopted. MSSIC was created because it was believed that it would provide the required financial security, a belief predicated in part on MSSIC's exemption from Federal income taxation (Plaintiff's Exhibit No. 1, set out in App. A, *infra*, pp. 17-18). Thus, Maryland's attempted discharge of its governmental obligation to protect its citizens' savings accounts would be unduly inhibited by the imposition of the Federal income tax. See *Metcalf v. Mitchell, supra*, at 522-24. We submit, therefore, that MSSIC's income is immune from Federal income taxation.

IV.

MSSIC'S INCOME IS EXEMPT UNDER CODE SECTION 115(a)(1)

If this Court believes, as we think it must, that MSSIC is a State instrumentality, then, *a fortiori*, its income is exempt from taxation under Code Section 115(a)(1).[9] MSSIC's *only* function is essentially governmental in nature. MSSIC's creation resulted from the failure, indeed the fraudulent nature, of the private companies insuring savings and loan accounts prior thereto. These companies facilitated the scheme to defraud Maryland citizens of their

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[9] Section 115(a)(1) exempts "income derived from . . . the exercise of any essential governmental function and accruing to a state. . . ."

savings. Moreover, Congress itself has recognized the need for a governmental institution to insure savings and loan accounts — FSLIC.

To meet the statutory test, therefore, it is necessary only that MSSIC's income *accrue* to the State of Maryland and not that such income be paid into the State Treasury. Since Maryland is vested with the right to the income, such income must be said to accrue to the State. See Treas. Reg. §1.446-1(c)(1)(ii); *H. Liebes & Co. v. Commissioner*, 90 F. 2d 932, 936-37 (9th Cir. 1937). It follows, therefore, that MSSIC's income, if not exempt under Code Section 501 (c)(14)(B), is nonetheless exempt from Federal income taxation pursuant to Code Section 115(a)(1).

CONCLUSION

For the foregoing reasons it is respectfully submitted that the decision of the district court should be affirmed.

Respectfully submitted,

RICHARD W. CASE,
Counsel for Appellee.

Of Counsel:

P. DENNIS BELMAN.

APPENDIX A

PLAINTIFF'S EXHIBIT No. 1

Commission to Study the Establishment of a
State System of Insuring Deposits of
Savings and Loan Associations

Room 809, State Office Building
301 West Preston Street
Baltimore 1, Maryland

February 1, 1962

To His Excellency
J. Millard Tawes
Governor of the State of Maryland

To the Honorable,
The General Assembly of Maryland

In response to Joint Resolution No. 22 of the 1961 General Assembly, this Commission was appointed to study the establishment of a State system of insuring deposits of savings and loan associations in the State and now submits the following report.

In the course of its deliberations, the Commission has met with representatives of the savings and loan industry and has also conferred with officials of the Co-operative Central Bank of Massachusetts and the Ohio Deposit Guarantee Fund, the only organizations which are engaged in a comparable activity.

As a result of its studies, the Commission has reached the following conclusions:

1. That a system for insuring the free-share accounts of State chartered savings and loan associations is desirable and in the public interest.

2. That such insurance should be provided through a central fund financed by the insured associations as is done in Massachusetts and Ohio and that the faith and credit of the State should not be pledged.

3. That all of the sound and well managed Maryland savings and loan associations should be eligible for membership in the fund, but that their participation therein should be voluntary.

4. That the supervision of the participating savings and loan associations by a State regulatory agency is essential.

5. That exemption from Federal income taxation will be essential to the success of any fund for the purpose of insuring free share accounts.

As a result of these findings, this Commission recommends for the consideration of the 1962 General Assembly a bill creating a non-stock, non-profit corporation for the purpose of carrying out these objectives. The Commission has drafted a bill which, in its opinion, will serve this purpose.

DAVID R. COHAN
JAMES O'C. GENTRY
JOHN D. HOSPELHORN
MARVIN MANDEL
GEORGE V. PARKHURST
F. DOUGLASS SEARS
HARRY B. WOLF, JR.
JOHN P. ZEBELEAN
JOHN S. SHRIVER, Chairman

SUPREME COURT, U.S.

Office-Supreme Court, U.S.
FILED
JUN 19 1970
JOHN F. DAVIS, CLERK

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No. [redacted]

In the Supreme Court of the United States

OCTOBER TERM, [redacted] 1970

UNITED STATES OF AMERICA, APPELLANT

v.

MARYLAND SAVINGS-SHARE INSURANCE CORPORATION

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

REPLY BRIEF FOR THE UNITED STATES

ERWIN N. GRISWOLD,
Solicitor General

MATTHEW J. ZINN,
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530

In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 1575

UNITED STATES OF AMERICA, APPELLANT

v.

MARYLAND SAVINGS-SHARE INSURANCE CORPORATION

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

REPLY BRIEF FOR THE UNITED STATES

1. The court below held an Act of Congress unconstitutional. If such a result is required, it should be reached only after a full hearing in this Court.

2. The court below held Section 501(c)(14)(B) of the Internal Revenue Code unconstitutional because it could not find (J.S. App. A, p. 34) "any conceivable basis in fact" for the exemption of mutual insurers organized before September 1, 1957, and the taxation of those organized on or after that date. We have shown (J.S. 9–10) that there is a basis for the difference in treatment—preventing a proliferation of state-authorized insurance corporations which might adversely affect the Federal Savings and Loan Insurance Cor-

poration ("FSLIC"). The appellee has undertaken to discredit this purpose. While it concedes (Motion 7) that "it is Congress' prerogative to protect FSLIC * * *" it contends (*ibid.*) that a congressional purpose to "deter the formation of state mutual insurers * * * is an impermissible one * * *" and that "Congress may not deter the formation of state mutual insurers in order to protect the interests of their federal counterpart."

This argument obviously raises serious questions in the field of federal-state relations. Moreover, it does not rest on any question of discrimination between appellee and state mutual insurers organized before September 1, 1957, but rather on an alleged absence of congressional power to subject state mutual insurers, no matter when organized, to the general income tax. In other words, appellee is in the position of arguing that Congress is constitutionally compelled to extend a tax exemption to each state insurer on the date of its formation, because, not to do so, would deter the formation of additional state insurers.[1]

Congress unquestionably has the power to make the general income tax applicable to all state mutual insurers. It is not proper to view the general income

[1] This is not unlike appellee's alternative contention, pressed below and renewed in its Motion (pp. 12–14), that it is a state instrumentality exempt from tax under the doctrine of intergovernmental immunity. That contention and appellee's further claim (Motion 14–15) that its income is excludable from gross income under Section 115(a)(1) of the Internal Revenue Code were properly rejected by the court below. See J.S. App. A, pp. 17–25.

tax as a penalty, as appellee's argument implicitly assumes. So long as imposition of the tax is within Congress' taxing power and does not contravene any other provision of the constitution, that is sufficient to sustain its validity. Moreover, given Congress' undisputed fiscal power to create FSLIC, imposing the general income tax on state insurers to protect that federal instrumentality is within the scope of the necessary and proper clause. See *M'Culloch* v. *Maryland*, 4 Wheat. 316, 419; *Agricultural Bank* v. *Tax Comm'n.*, 392 U.S. 339.

Hopkins Savings Assn. v. *Cleary*, 296 U.S. 315, cited by appellee (Motion 7), is not to the contrary. In that case, the Court held (*id.*, p. 335) that Section 5(i) of the Federal Home Owners' Loan Act of 1933 encroached upon the reserved powers of the states in violation of the Tenth Amendment, insofar as it permitted the conversion of state savings and loan associations into federal associations in contravention of the laws of the state of their creation. *Hopkins Savings* cannot be read to mean that the federal government is constitutionally bound to foster the development of state savings and loan associations, much less state insurers of such associations. It held only (296 U.S. at p. 336) that, in those circumstances, Congress was without power "to put an end to corporations created by the states and turn them into different corporations created by the nation." Indeed, the Court recognized (*id.*, p. 338) that the result would be different "where the business of an association under charter from a state is conducted in such a way as to be a menace or obstruc-

tion to the legitimate activities of its federal competitors."

There is no question here involving a congressional attempt to put appellee or any other state mutual insurer out of business. What is at issue is congressional power to withhold the ultimate tax privilege—tax exemption—in a situation where the state insurers are not in competition with each other. Moreover, we have here, unlike the situation in *Hopkins Savings*, a clear indication that proliferation of state mutual insurers could prove "a menace or obstruction to the legitimate activities" of FSLIC. See Statement by Joseph P. McMurray, Chairman, Federal Home Loan Bank Board, in Hearing before the Senate Committee on Finance on H.R. 3297, 88th Cong., 2d Sess., pp. 9–10 (set out in J.S. App. E, pp. 45–49). Under these circumstances, appellee cannot escape the conclusion that there is a basis for the classification in Section 501(c)(14)(B) by reliance on the Tenth Amendment. "From the beginning and for many years the amendment has been construed as not depriving the national government of authority to resort to all means for the exercise of a granted power which are appropriate and plainly adapted to the permitted end." *United States* v. *Darby*, 312 U.S. 100, 124.

3. In holding that appellee was entitled to the refund of taxes here in dispute, the court below assumed, without discussion, that if Section 501(c)(14)(B) is unconstitutional, the proper remedy would be to extend the exemption to appellee by excising the cut-off date from the statute, rather than by

declaring the entire section a nullity. This assumption we believe to be unwarranted.[2] But whether warranted or not, the issue is not one that should be decided *sub silentio*. The concurring and dissenting opinions in *Welsh* v. *United States*, No. 76, this Term, decided June 15, 1970, show that the question of the appropriate remedy for an unconstitutional underinclusion in a statute is both difficult and important. It is one on which this Court should hear argument even if it were to conclude that Section 501(c)(14)(B) is unconstitutional.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

MATTHEW J. ZINN,
Assistant to the Solicitor General.

JUNE 1970.

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[2] Appellee's argument (Motion 10–12) that the original cut-off date in Section 501(c)(14)(B), September 1, 1951, was not a significant aspect of the legislation is negatived by the fact that when Congress amended the statute in 1960 to include the Ohio Deposit Guaranty Fund, it did not eliminate the cut-off date completely. It merely changed the date to September 1, 1957. See J.S. 8–9. Furthermore, the bill which appellee itself sponsored, when it sought legislative relief likewise did not provide an open-ended exemption, but limited the exempt class to those—including appellee—organized before January 1, 1963. See J.S. 9.

U.S. GOVERNMENT PRINTING OFFICE: 1970

PER CURIAM

SUPREME COURT OF THE UNITED STATES

October Term, 1970

UNITED STATES *v.* MARYLAND SAVINGS-SHARE INSURANCE CORPORATION

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

No. 160. Decided October 19, 1970

PER CURIAM.

This is a direct appeal by the United States from a district court judgment holding unconstitutional § 501 (c)(14)(B) of the Internal Revenue Code of 1954, 26 U. S. C. § 501 (c)(14)(B), on the ground that it arbitrarily discriminates between Maryland Savings-Share Insurance Corporation (MSSIC), the appellee, and other similar nonprofit, mutual insurers.

MSSIC was established by the Maryland Legislature with the object of insuring the accounts of shareholders of member savings and loan associations. Although first chartered in 1962, it seeks the benefit of § 501 (c)(14)(B), which exempts from tax nonprofit corporations such as petitioner but only if organized before September 1, 1957.[1] MSSIC's position is that September 1, 1957 is an arbitrary and unconstitutional cutoff date which must be excised from the section, leaving the section applicable to all corporations of the same nature as itself regardless of the date of their creation. We do not agree.

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[1] Internal Revenue Code § 501 (c)(14)(B), 26 U. S. C. § 501 (c)(14)(B), provides:

"(B) Corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of shares or deposits in—

"(i) domestic building and loan associations,

"(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

"(iii) mutual savings banks not having capital stock represented by shares."

Prior to 1951, all savings and loan associations were exempt from taxation of income derived from their operations. Also exempt were nonprofit corporations which insured the savings banks. In 1951, the savings bank exemption was discontinued, on findings that the industry had developed to a point comparable to that of commercial banks. The exemption for insurers, however, was continued, provided they were already in existence as of September 1, 1951. See Revenue Act of 1951, § 313 (b), 65 Stat. 490; S. Rep. No. 781, 82d Cong., 1st Sess., 2 U. S. Code. Cong. & Ad. News 1969, 1991–1997 (1951). As of that date three private insurers fell within the scope of the section—two of them in Massachusetts and one in Connecticut. Then, in 1956, a fourth such corporation was organized in Ohio, and four years later Congress moved the cutoff date forward to September 1, 1957. Act of April 22, 1960, 74 Stat. 54.

In 1963, a similar bill, H. R. 3297, 88th Cong., 1st Sess., which would have moved the cutoff date forward to January 1, 1963, for the benefit of MSSIC, passed the House, but was never reported out by the Senate Finance Committee. Testimony before the committee indicated that continued forward movement of the date might lead to proliferation of state insurers that could hinder the operations and threaten the financial stability of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation. See Hearing before Senate Committee on Finance on H. R. 3297, 88th Cong., 2d Sess., 9–10 (1964).

Against this background, the District Court's invalidation of § 501 (c)(14)(B) was error. The fact that Congress enacts a statute containing a "grandfather clause," which exempts from the general income tax certain corporations organized prior to a specified date, does not of itself indicate that Congress has made an arbitrary classification. Cf. *Stanley* v. *Public Utilities Comm'n*, 295 U. S. 76 (1935); *Sperry & Hutchinson Co.* v. *Rhodes*, 220 U. S. 502 (1911); *Watson* v. *Maryland*, 218 U. S. 173

(1910); *Sampere* v. *New Orleans*, 166 La. 776, 117 So. 827 (1928), aff'd *per curiam*, 279 U. S. 812 (1929). Normally, a legislative classification will not be set aside if any state of facts rationally justifying it is demonstrated to or perceived by the courts. *McDonald* v. *Board of Election Comm'rs*, 394 U. S. 802, 809 (1969); *McGowan* v. *Maryland*, 366 U. S. 420, 426 (1961); *Standard Oil Co.* v. *City of Marysville*, 279 U. S. 582, 586–587 (1929). See also *Watson* v. *Maryland*, *supra*, at 178. Here the legislative history of H. R. 3297 affirmatively discloses that Congress had a rational basis for declining in 1963 to broaden the exemption by extending the cutoff date of § 501 (c)(14)(B). Just as a State may provide that after a specified date newly established common carriers must obtain state approval before entering into business so as to prevent proliferation of such carriers and excessive use of the State's highways, see *Stanley* v. *Public Utilities Comm'n*, *supra*, similarly Congress does not exceed its power to tax nor does it violate the Fifth Amendment when it refuses to exempt from tax newly formed corporations, the multiplication of which might burden otherwise valid federal programs.[2]

Having noted probable jurisdiction by order of October 12, 1970, we now reverse the judgment of the District Court.

So ordered.

MR. JUSTICE HARLAN, considering that the issues in this case are deserving of plenary consideration, would set the case for argument.

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[2] The District Court's reliance on *Mayflower Farms, Inc.* v. *Ten Eyck*, 297 U. S. 266 (1936), was misplaced, since, according to the Court in that case, the legislative record contained no affirmative showing of a valid legislative purpose. We thus need not pass upon the continuing validity of *Mayflower's* holding. We also find unpersuasive MSSIC's remaining argument that it is an instrumentality of the State and hence entitled to exemption from federal taxation under the doctrine of intergovernmental immunity and under § 115 (a)(1) of the Code, 26 U. S. C. § 115 (a)(1). The District Court properly rejected these arguments.